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DEBT SERVICING OF PAKISTAN: CAPITALIZING ON CHINESE INVESTMENT

Ali Haider Saleem

Pakistan has several times turned to external sources for development and economic restructuring purposes. The amount of debt Pakistan has accumulated over the years is now becoming a serious challenge. Moreover, Pakistan has been unable to utilise the borrowed resources efficiently which has placed the economy under financial stress. This paper will examine how the China-Pakistan Economic Corridor (CPEC) can offer support in overcoming the mounting external debt problem of the country. It will look at various aspects of CPEC which can help Pakistan generate foreign exchange earnings and reduce import costs. It will also discuss how Pakistan can reduce its dependence on foreign debt and become a more resilient economy. This paper also explores the limitations of CPEC in helping the government overcome its debt crisis and offers recommendations for utilising the Chinese investment to address debt- obligation challenges faced by Pakistan. It argues that the government must apply a comprehensive strategy for servicing its external debt.

Introduction

The future of Pakistan's economy relies heavily on the China-Pakistan Economic Corridor (CPEC). The economic activity in the country has been stimulated since the mega project was launched in 2015. That said, there are many long-term challenges hanging over Pakistan's economy. The amount of external debt accumulated in recent years has placed the macroeconomic outlook in a dismal position. Paying off debts is very challenging for developing countries like Pakistan. In addition, debt servicing has severe economic implications as well.

Pakistani governments have accumulated external debt in successions and, by doing that, have burdened the country with debt obligations. For several reasons, the loans taken have not been utilized to improve the overall economic condition. In contrast, the macroeconomic position of the country has suffered. As a result, Pakistan has fallen victim to 'debt overhang,' which is a situation where a country struggles to pay its past loans. Taking new loans to pay back previous ones provides little relief and mostly aggravates the crisis.

Most of Pakistan's debt accumulated over the years is due to fiscal mismanagement and inefficiencies. Pakistan has regularly approached international institutions in order to make up for its macroeconomic shortfalls. The conditions for such loans slow down economic activity as funds must be directed towards structural adjustments. Under such financial constrictions, it becomes difficult to attract foreign investment.

Before signing of the CPEC in April 2015, Pakistan was finding it very difficult to finance projects to support economic activity. Poor infrastructure, energy crisis, struggling industries, political instability and inadequate policies were placing a heavy toll on the country's economy and dragging it further into trouble. China's decision to invest in various sectors in Pakistan significantly helped in decelerating this trend.

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CPEC initiated multiple projects across the country. These included power plants, development and up-gradation of roads and railways, construction of industrial zones, and development of Gwadar Port. For any developing country, infrastructure holds the key for its economic progress.

With this background, this paper will explain how CPEC can support Pakistan in servicing its external debts and also recommend policies which will enable the country to make the most out of this opportunity.

Rising Debt and Its Implications

According to Pakistan's Ministry of Finance, the root cause of increase in debt is fiscal imbalances.1 Fiscal profligacy in the recent decades has regularly pushed the country to seek financial assistance from abroad. Inefficient use of borrowed resources and failure to make structural adjustments has set in a vicious cycle in Pakistan's economy. Fiscal deficit leads to borrowing which increases debt and, as the debt increases, the interest payments rise as well. This pushes towards further negative imbalance. Pakistan has suffered for its fiscal indiscipline in terms of deceleration in economic growth, lower investment, and increase in unemployment.

There is a negative impact on the net inflow of foreign resources when the liability of debt service payments increases. According to the Ministry of Finance, Pakistan spent US$4.794 billion on repaying external loans and interest from July through May 2016-17.2 rising repayments have also hindered Pakistan's economic growth. The weakening of the Pakistani rupee also intensifies the pressure on the country's economy. Moreover, with ever-increasing imports and a poorly performing export sector, Pakistan is faced with a daunting challenge to pay its external debts.

From 2016-17, Pakistan's external debt and liabilities amounted to US$79 billion. This was a surge of US$14 billion from 2013-14. With this rise, Pakistan's overall government debt stood at 69.1 per cent of Gross Domestic Product (GDP) from 2016-17.3. A World Bank study suggests that each additional percentage point of debt above 64 per cent slows growth by two per cent each year.4 Therefore, further delay in implementing a right strategy will only aggravate the crisis.

Significance of CPEC

In financial year 2016-17, Pakistan declared a budget deficit of a record US$12 billion. As most of CPEC projects are under construction, there is a time lag before Pakistan can benefit from them. Moreover, the import costs associated with CPEC projects has also placed a burden on the economy. However, it is expected that once the projects become operational, Pakistan will be able to generate much greater revenues than the initial costs. The volume of planned investment under CPEC was increased from US$46 billion in 2015 to US$62 billion in 2017. More and more projects are being added to an already impressive portfolio. In the coming years, these projects will play a pivotal role in turning the fortunes of Pakistan's economy.

Reckless borrowing by the government since 2008 has placed the economy under serious threat. In this period, the external debt increased sharply while foreign earnings and exports have experienced relatively slower growth. Prior to CPEC, poor economic growth was also adding pressure to macroeconomic stability of Pakistan. However, that pressure has now eased as the economy has grown by more than four per cent on average since 2013. CPEC has been identified as a key factor by the Asian Development Bank (ADB) for increased economic activity and investor confidence. The energy crisis and infrastructure constraints deprived the economy from nearing its true potential. The export sector is one of the most adversely hit. The increase in costs and limited access to markets has made Pakistani exporters uncompetitive globally.

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With multiple energy and transportation related projects underway, the business community has been provided with better opportunities that they can look forward to.

The role and active involvement of China in CPEC should also be considered as its major strength. After the US, China's US$12 trillion economy is the second largest in the world and is also the main trading partner of many countries around the globe. Even countries like Japan and India, despite having political and territorial disputes with China, have economies that rely heavily on China. In Pakistan's case, decades-long friendly ties with China add further advantage. In the coming years, the CPEC can provide great benefits to Pakistan and prove to be another win-win avenue for cooperation.

Capitalizing on CPEC

Pakistan should be mindful that CPEC cannot address the challenges faced by the economy on its own. Overcoming debt crisis has proven to be a tough challenge for many countries. Several measures are required to be taken if gains from CPEC have to be consolidated. Failure to do so will leave the economy without much improvement and CPEC will be considered as another lost opportunity for Pakistan.

Importance of Fiscal Discipline

Pakistan completed a 36-month-long US$6.4 billion International Monetary Fund (IMF) bailout programme in 2016 and was able to meet "all indicative targets and benchmarks" according to IMF Mission Chief to Pakistan, Harald Finger. For four consecutive years, Pakistan's fiscal deficit has continuously fallen and it stood at 4.6 per cent in the financial year 2016. The implementation of economic reforms has improved the macroeconomic position of the economy and helped in gaining the status of emerging market from Morgan Stanley Capital International (MSCI).

Despite all these positive developments, there are still plenty of challenges ahead for the reform agenda of the government. In financial year 2017, the fiscal deficit has fallen even further but not as much to meet the set target. The IMF is warning that "a number of challenges in the fiscal, external and energy sectors could affect the hard-won stability gains in the period ahead." It is calling for "strong efforts with respect to fiscal consolidation and the implementation of key structural reforms, and vigilance in managing the country's external position."

Pakistan has been a loan-dependent economy and if it fails to improve its fiscal standing than investor confidence will start diminishing. This, in turn, will offset the positive impact of CPEC on the country's macroeconomic outlook. The debt-loaded economy will also find itself struggling to meet the paybacks of CPEC if fiscal indiscipline is not kept in check. The government has been borrowing from both domestic and international sources. The Ministry of Finance revealed that domestic debt servicing reached Rupees 1220 billion in financial year 2017, higher by Rupees 70 billion compared to financial year 2016.9 Failure in making necessary reforms and consolidating gains will continue to burden the economy and halt growth. Moreover, the country will also find itself looking towards another bailout package. The government must ensure that the economy remains stable without accumulating an unsustainable level of debt.

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Current Account Improvement

Export earnings are essential for paying back external loans. Pakistan's export performance has been poor in recent years while import expenditure has consistently been on the rise. In the financial year 2017, the current account deficit stood at a record US$12.09 billion. The deficit registered in the balance of goods and services was US$30.5 billion compared to US$22.7billion in the fiscal year 2015-16.

In the form of CPEC, there is a strong potential for Pakistani exporters to increase their financial gains. The investment in energy and communication infrastructure will enable them to expand their production and compete with their international rivals. The government needs to facilitate the exporters along with providing adequate protection from foreign competition. In the last decade, many local businesses have suffered from lack of government intervention which has resulted in depletion of export revenue. While there is an urgent need to enhance trade ties, the government must be mindful of the concerns of local industries. Pakistan's trade deficit has worsened against China due to the Free Trade Agreement (FTA) between the two countries. Pakistan needs to ensure that mutually beneficial arrangements are in place.

The government should re-adjust its tax policies along with broadening the tax base. Manufacturing contributes 13.5 per cent to GDP while its share in taxation is at 58 per cent. On the other hand, retail and wholesale constitutes 18.5 per cent of GDP while the sectors contribution merely 1 per cent in tax revenues. The manufacturing sector should be provided relief to encourage production of export goods. This will also attract more investment in the sector.

The Special Economic Zones (SEZs) planned under CPEC will be pivotal in this regard. Pakistan should look to emulate Chinese success with the SEZs. The creation of SEZs since the 1980s has played an instrumental part in China's economic rise. The SEZs supported the integration of the Chinese economy with the global economy. By attracting foreign investments and technology, the Chinese government was able to utilise their natural resources and provide employment to millions of people. One of the first locations in China to become a SEZ was the southern city of Shenzhen, adjacent to Hong Kong. SEZ status turned a small town into a thriving city and a trading hub. International companies rapidly set up their operations in the city after realising the potential of the city. New jobs were created, and the population increased from 30,000 in 1979 to 8.6 million in 2007. The GDP of Shenzhen reached US$100 billion after years of rapid growth and it was the first Chinese city where GDP per capita increased to beyond US$10,000.

Construction of SEZs in Pakistan will boost production in the country and enhance export capacity. SEZs can also be utilised to promote an import substitution strategy. Many consumer items imported in Pakistan can be produced inside the country if foreign firms are provided the right incentives and facilities. They will ease external vulnerabilities and lower import expenditures.

The flagship project of Belt and Road Initiative (BRI), CPEC, should be used to enhance connectivity with other participating countries. This platform is an ideal opportunity to secure new markets for Pakistani goods. Moreover, CPEC has the potential of becoming a transit corridor in the region, thereby providing another opportunity for generating revenue from abroad. Remittances are a major source of foreign exchange earnings for Pakistan. However, the changing geopolitical situation can lead to reduction in the flow of money coming to Pakistan from various parts of the world. Pakistan has to be proactive about risk mitigation strategies. Provision of jobs under CPEC will cater to this challenge and help Pakistan absorb any future shocks.

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Promotion of Domestic Finance

The World Economic Forum estimated that US$60 trillion will be required for global infrastructure in the period 2013-2030 to accommodate the needs of the world's growing population. Pakistan has a particularly high growth rate with predictions that the population will double by the middle of the century. This population growth has been dubbed "catastrophic" as most of the population will consist of young working-age people. With the rapid increase in population and the size of economies, the current infrastructure will not be adequate to support economic activity in different parts of the world. In the developing countries, this is a grave concern as they lack access to financial resources. For Pakistan, however, CPEC has provided much-needed funds for the development of infrastructure projects and has covered up Pakistan's own limitations of funding projects in the country.

However, the financing that initiated economic growth in Pakistan has also placed additional stress on the external account. The loans have increased Pakistan's debt burden. Currently, Pakistan has to rely on Chinese funding but it should encourage mobilisation of domestic resources for development projects as well. Domestic financing will also be critical in sustaining Pakistan's economic growth.

Efficient mobilisation of resources is essential for boosting economic activity. For this purpose, a robust and effective financial system is critical. A study conducted by the State Bank of Pakistan suggests that household savings placed in real estate and precious metals in Pakistan need to be unlocked and then channeled into productive investments. The government's heavy reliance on the commercial banks for financing its fiscal deficit eliminates the incentives for banks to offer attractive savings schemes and strengthen their capacity to finance long-term projects. The reduction of the budget deficit can vitalize the banking sector and amplify its role in the economic development of the country.

The expansion of Islamic banking network and financial instruments is also well endorsed. Malaysian economy, by focusing on domestic financing, established Islamic finance institutions and an efficient capital market which should serve as a benchmark for Pakistan. A study of the Malaysian economy shows that Malaysia's capacity to generate and mobilize domestic savings was a major factor behind its economic development. It adds that foreign investment supplements should not be considered as a replacement for domestic investment. The study underscores that "It was the widening private savings-investment gap and/or deficit budgets which led to increased dependence on external borrowing and foreign short-term capital flows, both of which proved to be extremely dangerous, as demonstrated by the 1985-1986 and 1997-1998 economic crises."

Investment in Energy

A major part of the CPEC project is devoted to meet the growing energy requirements of the country. To increase GDP and provide relief to domestic consumers, the Government of Pakistan is undertaking several energy projects. Other than CPEC, many energy projects are also underway including: Balloki, Bhakki, and Neelum-Jhelum power plants. Expansion work on existing power plants is also being undertaken. The Early Harvest Program (EHP) of the CPEC (2013-18) added more than 10,000 MW of electricity. The energy ventures include coal, hydroelectric, wind, and solar based projects. China and Pakistan are also building a vast network of liquefied natural gas and oil pipelines to facilitate the flow of these vital inputs to support industrial activity. These pipelines will also speed up delivery of these resources to China. Pakistan also expects to receive an additional 1000 MW of electricity from Central Asia through the CASA- 1000 project within the next few years.

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At present, oil and gas are the main resources that cover Pakistan's energy requirements. Indigenous resources of oil do not meet the present and future requirements of Pakistan's economy. As a result, Pakistan imports large quantities of oil and oil-based products from the Middle East. Other major consumption of imported energy is in transportation. The demand of the transport sector is also expected to rise further in the coming years due to expansion of the economy and greater regional connectivity.

The diversity of energy projects under the CPEC portfolio is an encouraging sign. In order to reduce dependence on imported oil to meet the energy requirements, Pakistan needs to capitalise on its abundant renewable resources like hydro, wind, and solar. Thus, energy projects under CPEC can help reduce import costs for Pakistan. The government should facilitate further development in this sector as Pakistan has enough resources to export energy to other countries.

The energy crisis has been extremely harmful to the local industries. Shortage of electricity and higher costs have made Pakistani exporters less competitive compared to the producers in other parts of the world. As a result, Pakistan has constantly seen its share of exports declining in the international markets. The completion of energy projects will address this problem to a certain extent. The government will still have to intervene in the market place to keep the price of electricity from increasing too rapidly. The energy sector reforms are critical to address the present issues and prepare for the future. The systems for transmission and consumption of energy need to be improved as well. Moreover, the global energy markets are changing due to climate action and new discoveries. The implications for such development on Pakistan must be evaluated. Future investments in the energy sector should consider the changing dynamics of this sector.

Way Out for Pakistan

In the form of CPEC, a new wave of development is taking place in the country which will certainly help Pakistan to fix its economic ills. However, macroeconomic complexities must be considered while addressing certain challenges. As economic factors are deeply inter-connected, there is a need for a broad and comprehensive strategy. It is equally important to realise the cause of a certain issue and to develop policies that can facilitate economic growth. There are examples that can help direct Pakistan's strategy. For instance, the Turkish economy was volatile in the 1990s and found itself in a severe financial crisis in 2001. Macroeconomic imbalances had serious negative consequences. The growth rate fluctuated, and economic uncertainty ensued. The turmoil left Turkey with a high level of public debt.

To address this issue, the policymakers initiated wide-ranging reforms which included maintaining fiscal discipline to foster medium-term debt sustainability; strengthening the banking system; improving the investment climate to attract larger amounts of foreign direct investment (FDI); speeding up the privatization of public enterprises; and initiating structural reforms. These measures helped the central government's public debt fall from 69.2 per cent of GDP in 2002 to 39.6 percent in 2007. Simultaneously, the share of external debt in total central government debt decreased from 38.2 per cent in 2002 to 23.4 per cent in 2007. On the back of policy adjustments, the Turkish economy experienced rapid growth in the five years after the crisis. Turkey's experience shows that economic activity in the country must be facilitated with well-designed and well-implemented reforms. For Pakistan, CPEC will open economic opportunities but it alone cannot transform the economy.

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The caretaker government which took charge for a brief period prior to the 2018 general elections in Pakistan prepared a "stabilisation and economic growth policy recommendation paper" which noted that US$9.3 billion would be required to cover Pakistan's debt obligations in the coming fiscal year. It suggested the depreciation of rupee, the raising of taxes and the reduction of development funding to address this mounting challenge. Strengthening of public institutions will play a key factor in this regard. By expanding and improving their functioning, the government will give itself a much better opportunity to identify and address relevant problems. Greater confidence and optimism can be generated by improving the performance of government institutions. The situation calls for looking abroad to relieve the stress on Pakistan's economy. Foreign governments and financial institutions can be encouraged if the country's institutions are able to present a serious and dedicated approach.

There is a need to accommodate such recommendations and lessons in the framework of CPEC and utilize Chinese capital accordingly. The projects under CPEC should be stringently monitored and authorities should ensure their timely completion. This will not only save the resources, but will also allow the loans to be paid back on time. In Pakistan however, the deadlines for the completion of large-scale projects have rarely been met. Short-term and small-scale projects offer swift returns and are easier to implement. Economic viability must be given preference over the political weight of projects. CPEC has to be taken as a commercial venture and the focus of the policy makers must be market-oriented.

Debt Management

Mismanagement of debt creates economic uncertainty, triggers inflation and exchange rate fluctuations which is highly undesirable for promoting economic activity and attracting foreign investment. The government's ability to carry out development initiatives also declines as resources become limited due to debt servicing obligations. Delays in paying back loans causes additional costs and limits policy options in the future. The issue of Pakistan's external debt must be taken seriously by the government and lawmakers. The current trends suggest that Pakistan is heading towards a crisis. In the last few years, almost all the debt sustainability indicators have worsened. If the challenge is not met with adequate policy responses, then the country will find itself in a precarious financial situation.

Debt is not a bad thing if it is used efficiently to generate enough resources to boost long-term economic growth. However, the current development strategy based on debt must be revised. Pakistan has not been able to benefit from this strategy like some of the other countries. There is a dire need to improve the taxation system so that the government can rely on its own resources to fund development and to avoid placing extra burden on the economy. Fiscal indiscipline also forces a country to accumulate short- term loans. Because of their shorter maturity period, economic growth is undermined. The 2019 Regional Economic Outlook for Middle East and Central Asia released by IMF states that "vicious cycle of low growth and rising debt has limited space for growth-enhancing capital investments. As a result, many countries have found it difficult to reduce debt levels, even those tightening their fiscal stance."19 Strict measures are also required to overcome the corruption related to the use of funds. The rise in the fiscal deficit over the years reflects that program loans have not been used efficiently. The government should focus on making the system more efficient and improving the overall macroeconomic environment in the country. If significant portions of revenue generated from CPEC projects in the coming years get diverted to servicing external debt, then the benefits of the CPEC for the people of Pakistan will be curtailed.

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Conclusion

CPEC provides an excellent opportunity for Pakistan to overcome many of its economic problems. Pakistan's need to generate employment opportunities for the rapidly expanding youth population and meeting domestic and commercial energy demands rests heavily on smooth implementation of CPEC projects. While CPEC can boost economic activity, it needs to be matched by policy adjustments. Pakistan must enhance its debt servicing capacity and reduce its dependence on external financing. For that, the government must improve the efficiency of the tax system, mobilize domestic resources, design policies beneficial to exporters, counter corrupt practices, make the environment more attractive for foreign investors, and ensure timely and efficient completion of projects.

The issue of external debt has been a persistent one for Pakistan. In the past, Pakistan has been unable to make use of the loans it has received for development purposes. Pakistan must learn from past mistakes and adopt stringent measures. By utilizing Chinese investment efficiently, Pakistan's economy can be lifted from its struggles and placed on a steady growth track. Practical implementation of CPEC should be more realistic than media projections. Failure to build on this opportunity and adopt policy adjustments will worsen the macroeconomic outlook and pile up debt obligations to Chinese investors.

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